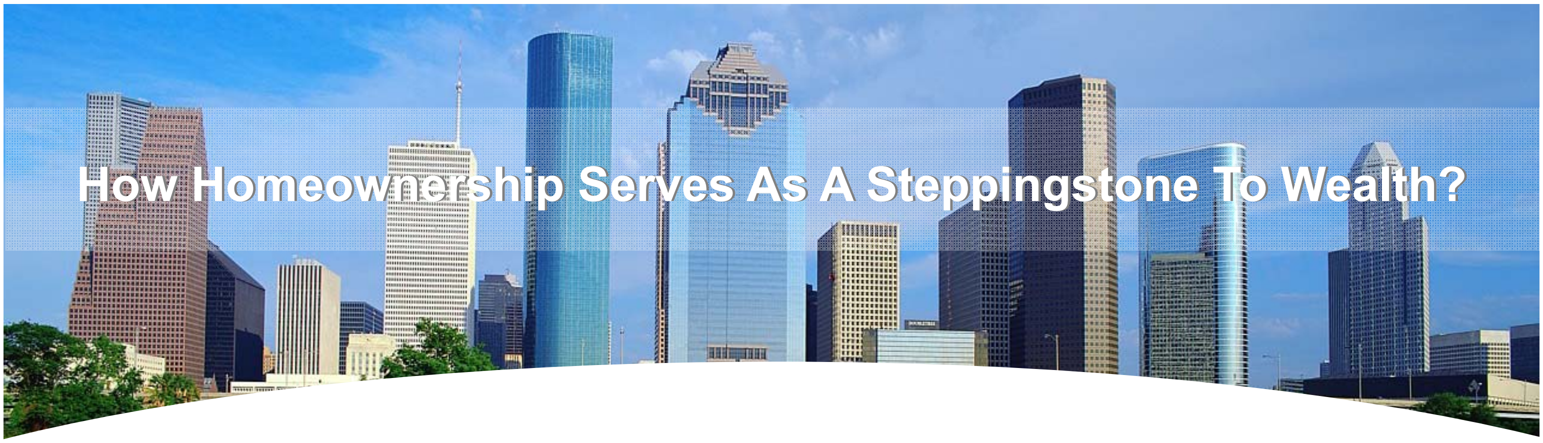

How Homeownership Serves As A Steppingstone To Wealth?

A recent editorial in the New York Times focused on homeownership and wealth creation, drawing on research from the Joint Center for Housing Studies at Harvard University and concluding that “as a means to building wealth, there is no practical substitute for homeownership.”

But just why is homeownership so important to building wealth? Here’s what the researchers at Harvard found in their 2013 research, and what it means for you today.

A Mortgage Forces You to Save

Buying a home through a mortgage forces savings through the form of the monthly payments of principal. Rent vs. buy arguments normally focus on the monthly payments, and the buying cost is a function of the monthly mortgage payment as well as escrows (insurance and property taxes).

But the mortgage payment comprises an interest component and a principal component, and the way the payments are split between interest and reduction of principal (the total amount borrowed) changes over time. In general, more interest is paid at the beginning of the mortgage. The longer you have the loan, the greater the share of your payments that is going to pay it down.

The payment of principal as the loan ages is, therefore, a forced savings plan whose deposits are growing—without any more being taken out of your pocket.

Homes Deliver Real Appreciation Over Time

We now have lived through periods of abnormal price increases as well as periods of abnormal price declines. Even so, when you take the long view, the compounded annual return of home prices has exceeded inflation by close to a full percentage point. In other words, while there are periods of above normal and even negative changes in value, home prices increase faster than inflation over time.

And those increasing values compound over longer periods of time. For example, the Harvard study highlighted that if an owner had experienced the average gain in home prices from 1975 to 2012 as measured by a common home price index, that owner would see have seen a real, inflation-adjusted gain of 26% over 30 years.

That means that after adjusting for inflation, at the end of a 30-year mortgage, a typical home would be worth 26% more in current dollars.

Buying With a Mortgage Increases the Returns of Owning a Home

The Harvard paper used the example of a buyer putting down 5% and experiencing 4% appreciation. After five years, the house would be worth 22% more—or more than five times what the owner put down.

Homeowners Enjoy Multiple Tax Benefits

Many homeowners enjoy the benefit of the mortgage-interest deduction, which enables them to deduct the annual interest paid on a mortgage along with property taxes. Furthermore, substantial gains (up to as much as $500,000) are exempted from capital gains upon the sale of a home.

Homes Protect the Owners From Rising Costs

As discussed above, home prices historically outpace inflation—the result of prices rising over time. But buying a home with a mortgage actually provides even more of a protection from a very real threat in the form of rising rents.

A mortgage locks in the majority of a homeowner’s housing costs. As time goes by, the monthly payment remains the same, yet because of inflation the real payment, cost actually declines. That means that over time, homeowners pay an increasingly smaller share of income on housing.

The Harvard study cited these stats: Assuming a 30-year fixed rate mortgage, inflation of 3% and 1% growth in real (inflation-adjusted) home prices, property taxes, insurance and maintenance costs, real monthly housing costs would decline by about 10% after five years, 15% after 10 years and 30% by the last year of the mortgage. Then when the mortgage is paid off—and the home is owned free and clear—the costs of owning in real terms are less than half the payments made at the time of purchase.

The alternative to owning does not have such a pleasant long-term outcome. Rents would at least keep pace with inflation, meaning that the renting household would never see their real housing costs decline.

Homeownership remains a key part of the American dream for many quality-of-life reasons—like simply having a place to call your own. But as this research indicates there is also a clear financial benefit as well: Owning a home over time enables growth in household wealth.

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